No. 11823

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

LEO M. HARVEY and LENA P. HARVEY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

OPENING BRIEF FOR PETITIONERS.

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JURISDICTION.

The jurisdiction of this Court is invoked under Section 1141(a) of the Internal Revenue Code. Petitioners are residents of Los Angeles, California.

ISSUES PRESENTED.

The controversy involves a proper determination of the petitioners' liability for federal income taxes for the calendar years 1939, 1940 and 1941. The issues are:

1. Whether the gain realized by petitioners on account of the installment sale of certain patents constituted capital or ordinary gain.

2. Whether certain portions of the sales price paid by petitioners to others can properly be excluded from or offset against the sales price received, and whether in that connection the Tax Court should have granted petitioners' motion for rehearing.

3. Whether the Tax Court should have granted petitioners' motion for judgment on the pleadings.

STATEMENT.

The following statement is drawn from the Tax Court's findings of fact, from the evidence and from other parts of the record. The evidence is cited, not in derogation of the findings, except where so expressly stated, but in supplement thereto. Petitioners request remand, if necessary, for the purpose of obtaining findings covering the evidence so cited.

General Facts.

1. Petitioners are husband and wife residing in Los Angeles. They filed separate returns for the taxable years on a community and accrual basis [R. 43]. Unless otherwise indicated, the term "petitioner" in the singular will hereinafter be used to refer to petitioner Leo M. Harvey.

Facts Relative to Issue No. 1.

2. By written agreement dated March 21, 1938, petitioner sold certain patents and applications for patents, both foreign and domestic, to the Gerrard Company, Inc., hereinafter referred to as "Gerrard." The patents so sold by petitioner covered inventions in the round wire tying and the flat band strapping and tying fields. Gerrard paid petitioner as consideration $25,000 cash upon execution of the agreement and delivered to petitioner 10 negotiable promissory notes, each in the amount and each having then a fair market value of $40,000, all dated April 2, 1938, numbered 1 to 10, inclusive, and maturing serially commencing April 2, 1939, and thereafter on April 2 of each succeeding year through April 2, 1948. These notes were tendered and accepted as payment. During the taxable years here involved these notes were paid when due [R. 43].

3. While the patents sold included patents in the round wire as well as the flat band field, the entire value represented by the proceeds of the sale was in the flat band patents [R. 71-73, 105]. This value resulted from a minimum royalty of $30,000 per year which Gerrard was obligated to pay petitioner under license contracts covering the said flat band patents [R. 71-73].

4. There were no royalties paid on the flat band patents other than the minimum royalties above referred to [R. 73]. There was no royalty contract covering the round wire patents [R. 73, 91-102].

5. Petitioner, since about 1914, had been sole proprietor of a business known as Harvey Machine Company. This business consisted primarily of making industrial machinery on special order [R. 45]. Petitioner commenced developing inventions in the wire-tying field in the middle 1920's, and subsequent thereto and from time to time obtained the patents sold to Gerrard [R. 45]. The expense of developing these inventions was deducted as business expense of Harvey Machine Company [R. 45].

6. Some time in 1930 petitioner licensed Gerrard to operate under certain of the flat wire tying patents at a minimum royalty of $30,000 a year (referred to above in paragraph 3), which petitioner received from 1931 to 1937, inclusive. In 1938 and by the terms of the sales contract Gerrard agreed to pay petitioner certain amounts on account of royalties due up to and including March 31, 1938. The royalty payments received by petitioner prior to 1938 were reported by petitioner as income from the business of Harvey Machine Company [R. 45-46, 57].

7. Under the license contracts covering the flat band patents petitioner made only the first finished models. That

was sometime in 1930 or 1931 [R. 82]. After that his only work in connection with those patents was to complete applications and improvements in process [R. 82-83]. None of such work, however, continued into the last two or two and one-half years prior to the sale of the patents on March 21, 1938 [R. 83]. Except for the first finished models, made by him in 1930 or 1931, petitioner never made any machine covered by the said patents [R. 83].

8. The said flat band patents were wholly unrelated to petitioner's business, and were wholly unrelated to the patents in the round wire field. In that respect petitioner testified, without controversion, as follows:

A. On direct examination—

> "Q. Were these flat band patents in any way pertinent to or necessary to or were they in some way involved in the business which you were carrying on in the last two or three years or so prior to that transaction? A. We never used the patent because we never made the machines.
>
> Q. Referring to the wire machine or wire tying trade, are round wire and flat wire or slot band wholly different fields of production? A. Yes, they are" [R. 83].
>
> "Q. Did the flat band patents have any relation in any respect to the round wire patents? A. None, because they are an entirely different art" [R. 69].

B. On cross-examination—

> "The object of this round wire and flat wire is the same, is to hold the box together, but the most distinctive feature between the two is to create a seal to hold it together so it won't come apart. On the round wire to make a seal is very easy, there isn't anything to it, it is just twisted. That is why people

can all get in the round wire business, but it is different in the flat band. People who are in the flat business don't nail off the wire" [R. 105-106].

9. Petitioner sold his wire-tying patents to Gerrard for the purpose of raising capital in order to branch out into larger business [R. 68].

10. Petitioner was not in the business of selling patents. Other than the patents involved here he never sold any patents to anyone. He never held any patents for the purpose of selling them [R. 81]. The sale of the patents involved here was not to a mere customer but to a person which already, and since 1930, had the use of the patents, and under a license obligating it to pay petitioner a minimum royalty of $30,000 per year [R. 45-46].

Facts Relative to Issue No. 2.

11. By written agreement and under circumstances hereinafter described petitioner paid his son Lawrence 20 per cent of the proceeds of the sale as received by petitioner. Petitioner also paid certain amounts to his brother Herbert from such proceeds. Herbert was thus paid $2,500 in each of the taxable years here involved [R. 43-44].

12. Petitioner's son, Lawrence, was an attorney about 28 years old in 1938. He assisted petitioner in *negotiating* the sales contract with Gerrard [R. 44]. Petitioner engaged Lawrence for this purpose [R. 107], instructing him to "make a deal" [R. 103-104, 107], and agreeing in advance to compensate him if he succeeded [R. 103-104]. After a deal was completed, the compensation agreement was reduced to writing [R. 104, 123]. Under said written agreement, dated April 2, 1938 (the very same day that the sale was completed—see paragraph 2 above), peti-

tioner agreed to compensate Lawrence for his efforts in connection with the sale of the patents by paying him 20 per cent of all proceeds of the sale as received by petitioner. Under this agreement petitioner paid Lawrence $8,000 a year during the taxable years [R. 44-45, 120, 123].

13. Petitioner employed as attorneys in connecton with the Gerrard deal, Max Schlesinger, who handled the tax aspects, one Rubin and a Walter Sheldon* [R. 44-45].

14. Before completing the sale of the patents to Gerrard petitioner sought tax advice and was advised that under the law the gain on the sale was capital gain [R. 118-119]. He believed also that since the payments to Lawrence would be ordinary income to Lawrence, while they would only reduce his own capital gain, there would

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*The Tax Court states in its findings [R. 45] that petitioner "also" employed as attorneys the three individuals named. The apparent implication is that he employed Lawrence as attorney. The fact that Lawrence was an attorney does not, of course, require the conclusion that his services in the Gerrard deal were as attorney, or solely as attorney. On the contrary, the Court itself in its findings with respect to Lawrence's services says only that Lawrence assisted petitioner in "negotiating" the sales contract with Gerrard. [R. 44.] The evidence amply supports this finding and shows also that Lawrence's principal efforts were as negotiator, not as attorney. [R. 107, 108—cross-examination.] Perhaps the Court used the word "also" inadvertently or did not intend the implication above mentioned.

With respect to Walter Sheldon the Tax Court in its findings [R. 45] added:

> "Walter Sheldon was paid $22,500 in 1938 for his services, which services among others concluded Sheldon's work in connection with the Gerrard sale."

There is nothing anywhere in the evidence to support the implication apparent in the word "concluded" that Sheldon rendered services in connection with the sale to Gerrard prior to 1938. The evidence, in fact, is clear to the contrary. [R. 104.] Nor was the sale even in petitioner's mind prior to 1938. [R. 68.] Perhaps, however, the Court meant "included" instead of "concluded."

be a net tax loss, to himself and Lawrence combined, because of said payments [R. 119-120]. On the basis of the returns filed by them there was, in fact, a net tax loss of $4,067.18 for 1938 and the taxable years here involved [R. 120-122].

15. Petitioner's brother, Herbert, had been an employee of petitioner, in connection with the business known as Harvey Machine Company, since about 1918 on a salary ranging from $500 to $1,500 a month [R. 45].

16. Petitioner developed the wire-tying inventions with the advice and assistance of Herbert. He paid Herbert 10 per cent of the $30,000 annual minimum royalty received by him from Gerrard [R. 46]. From the very beginning, each month that he received a payment from Gerrard, he paid Herbert his percentage [R. 77, 97]. He made these payments to Herbert because he considered Herbert's advice very valuable [R. 97]. In that connection petitioner testified:

> "It is not what you do in the daytime in the business, it is what you do in the evening and Sundays and holidays in discussing these matters and advising, I considered was valuable to me" [R. 97].

When the patents were sold petitioner settled with Herbert by agreeing to pay him in lieu of the 10 per cent of royalties, $2,500 out of each payment of $40,000 received from Gerrard [R. 77-78]. The sales contract with Gerrard, in which petitioner is referred to as "first party", provided *inter alia:*

> "It is understood and agreed that the aforesaid U. S. patent applications and inventions in the round wire and flat band strapping fields only and the aforesaid foreign patents, foreign patent applications and

inventions in the flat band strapping field only hereinabove referred to as being owned by first party and limited as aforesaid include not only patents, patent applications and inventions owned by first party, but also patents, patent applications and inventions, if any, owned by Herbert Harvey and in which either or both first party and said Herbert Harvey have an interest, and first party agrees that with respect to all said patents, patent applications and inventions, if any, owned by or in which Herbert Harvey has an interest, first party will cause said Herbert Harvey to execute and deliver all instruments and to do all acts and things which first party has herein agreed to execute and deliver and do with respect to patents, patent applications and inventions owned by first party" [R. 46, 67-68, 121].

Facts Relative to Issues No. 2 and No. 3.

17. In reporting the proceeds of the sale of these patents for income tax purposes petitioners excluded or deducted from the sales price the said amounts payable to Lawrence and Herbert respectively. The remainder of the sales price was reported on the installment basis and treated as capital gain, each petitioner reporting a community one-half [R. 44].

18. The election to report this sale on the installment basis was made by petitioners in their returns for the year 1938, under Section 44(b) of the Revenue Act of 1938; but otherwise their returns for 1938 were on the accrual basis. (Alleged and admitted in the pleadings. [R. 12, 30.]) Petitioner never regularly sold any property on the installment plan [R. 84].

19. The Commissioner disallowed (a) the treatment of the gain as capital gain, and (b) the exclusion or deduc-

tion of the amounts paid Lawrence and Herbert. The only explanation given therefor in his notice of deficiency to each petitioner is as follows:

> "It is determined that the entire $40,000.00 received in each year is taxable as ordinary income" [R. 21].

20. Petitioners petitioned the Tax Court for a redetermination, alleging as error the treatment of the gain as ordinary income, and the failure to allow the payments to Lawrence and Herbert, either as offsets against the selling price, or as deductions under Section 23(a)(2) of the Internal Revenue Code [R. 11]. Commissioner in his answer [R. 30-31] denied *inter alia* certain negative allegations of petitioners, including the following [R. 15]:

> "12. None of said patents were stock in trade of petitioner.
>
> "13. None of said patents were other property of a kind which would properly be included in the inventory of the petitioner if on hand at the close of the taxable year.
>
> "14. None of said patents were held by petitioner primarily for sale to customers in the ordinary course of his trade or business."

Petitioners made said allegations for the obvious purpose of taking the patents out of the following portion of the exception clause in the definition of "capital assets" in Section 117(a)(1) of the Internal Revenue Code [Appendix herein, p. 3]:

> "but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by

the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . ."

21. Petitioners thereupon filed motion for judgment on the pleadings [R. 39-41], on the ground (a) that the denial by Commissioner of the said negative allegations of petitioner amounted to an allegation by him that the patents did fall within said portion of said exception clause, (b) that a sale of property falling within said portion of said clause could not be a "casual" sale within the meaning of Section 44(b) of the Revenue Act of 1938 [Appendix herein, p. 1] and could not therefore be reported on the installment basis, and (c) that the said denial by Commissioner amounted as a result to an allegation that none of the gain on the sale of the patents was properly reportable in any of the years here involved, the said sale having taken place in 1938.

The Tax Court denied said motion for judgment on the pleadings. Commissioner, however, did not abandon his denial of said negative allegations of petitioners. On the contrary, at the trial, in his counsel's opening statement, he placed his position in that respect in clear, positive form, as follows:

> "Of course, it was an asset held by the Petitioners primarily for sale in the ordinary course of the trade or business. . . ." [R. 67.]

22. After decision by the Tax Court for the Commissioner petitioners filed motion for rehearing [R. 50]. The Court met the first ground of the motion by amending its

findings of fact [R. 56-57]. With respect to the remaining grounds, however, the Court simply denied the motion [R. 57]. The said remaining grounds, in brief, were as follows:

(a) That the Court in its opinion having considered the value of Lawrence's services as distinguished from the bona fides of his compensation, which alone petitioners had considered in issue, they desired now to call Lawrence as a witness in connection with such value.

(b) That the Court while finding that Lawrence did render services failed to place any value upon them.

(c) That the Court's conclusions in respect to Herbert were in conflict with the evidence and that petitioners desired to call Herbert as a witness for the purpose only of avoiding any implication that might have resulted from the fact that he had not been called.

Petitioners attached to the motion affidavits [R. 53-56] showing in substance what the testimony of said witnesses would be if they were called. As above stated, the Tax Court denied the motion. Petitioners then filed their petition for review by this Court.

ARGUMENT.

The gain realized by petitioners from the installment sale of patents to Gerrard in 1938 was capital gain. The statutory provisions in that respect cover all property, subject to specified exceptions. The provisions upon which respondent must rely are thus exception clauses and should be narrowly construed.

The said exceptions are:

1. Stock in trade of the taxpayer,
2. Other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year,
3. Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, and
4. Property used by the taxpayer in his trade or business and subject to the allowance for depreciation.

The patents involved here did not fall within any of the said exceptions. The Tax Court in its opinion stated that the patents were probably not within any of the first three exceptions, but did fall within the fourth. Its conclusion with respect to the first three exceptions is well supported by the facts. Petitioner was not in the business of selling patents. Nor was this sale a sale to a "customer" in the usual sense of that term. Nor did the sale take place in the "ordinary course" of his business.

As to the fourth exception the Tax Court was definitely in error. Under the circumstances of this case, this exception in the definition of capital assets should be narrowly construed and any doubt in its meaning should be

resolved in favor of the taxpayer. The reason is that the application of this exception to these petitioners is prejudicially retroactive, and is not within the intent of Congress.

Nor were the patents in fact used in petitioner's trade or business. For the purpose of this exception provision, use in the trade or business means such use at the time of sale. At the time of sale and for several years prior thereto, petitioner was a mere passive recipient of minimum royalties under a license of the said patents granted by him to Gerrard in 1930. The mere passive receipt of royalties is not in itself a trade or business. Nor is it made a trade or business merely because the property from which the royalties are derived may have originated in the taxpayer's trade or business. This is emphasized here by the fact that the patents were sold for the purpose of raising capital in order to expand the business; and it was to unfreeze capital for that very purpose that Congress enacted the capital gain provisions.

The payments to Lawrence A. Harvey and Herbert Harvey out of the proceeds of the sale should be allowed as an exclusion from or offset against the selling price. For this purpose it is only necessary to show that the payments were *bona fide* and were actually incurred in connection with the sale of the patents. It is not necessary to show that they were ordinary and necessary, or reasonable. The payments to Lawrence were *bona fide* and actually incurred in connection with the sale of the patents. The payments to Herbert were payments for his interest in the patents. In any event, the payments to Herbert were capital expenditures incurred by petitioner in connection with the patents and therefore deductible as offsets against the selling price. The Tax Court concluded that the services of Herbert were invaluable. It certainly therefore should

have allowed the deduction of a mere $2,500 out of each $40,000 payment received by petitioner.

In any case, as the Tax Court found, Lawrence and Herbert did render services. As a result, the Commissioner was in error in making no allowance at all. The Tax Court therefore could not, as it did, simply sustain the Commissioner but bore a duty to make a determination as to the value of those services and to allow at least such amount as deductions. To that end, if necessary, the Court should have granted petitioners' motion for rehearing.

Petitioners' motion for judgment on the pleadings should have been granted. A motion for judgment on the pleadings should be granted where a position taken by the opposite party on the facts, if it represented the truth, would require such a judgment and such opposite party fails to amend. The Commissioner in his answer took such a position because he took a position, *inter alia,* that the property fell within the first three exceptions to capital asset classification stated above, and such position is inconsistent with the inclusion in gross income in the years here involved of *any part* of the proceeds of the sale. The Commissioner, furthermore, after petitioners filed motion for judgment on the pleadings, pointing out the defect in his answer, made no attempt to amend. On the contrary, he reaffirmed the said position at the opening of the hearing, in express words. The motion for judgment on the pleadings should therefore have been granted.

POINTS OF LAW.

Issue No. 1: Whether the Gain Realized by Petitioners on Account of the Installment Sale of Certain Patents Constituted Capital or Ordinary Gain.

I.

The Statutory Provisions Upon Which Respondent Must Rely Are Excepting Clauses and Should Be Narrowly Construed.

The respondent's deficiency notice denies to petitioners the treatment as capital gain of the amounts received under the Gerrard contract on the ground that such amounts are "ordinary income." The deficiency notice contains no other description or explanation. The applicable statutory provision, Section 117 of the Internal Revenue Code, is, to the extent pertinent, given in the Appendix, p. 3. The words "ordinary income" appear nowhere in that provision. Those words have merely come to signify any income which is not gain on the sale or exchange of "capital assets."

Coming then to the statutory definition of the term "capital assets", the Committee on Ways and Means has stated:

> "It will be noted that the definition includes all property, except as specifically excluded." (Report—Ways and Means Committee, 73d Cong. 2d Sess., House Rept. 704, page 31; 1939-1 C. B. Part 2, p. 577.)

An excepting clause is to be narrowly construed. *U. S. v. Scharton,* 285 U. S. 518, 52 S. Ct. 416. The capital gain

provisions were enacted to make it possible for a taxpayer to dispose of items of investment property without being deterred by the high rates of tax otherwise applicable; for it was found that "an excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments." (Report—Senate Finance Committee, 75th Cong., 3d Sess., S. Rept. 1567, page 6; 1939-1 C. B. Part 2, p. 783.) The capital gain provisions should be interpreted so as to carry out that Congressional purpose. The very purpose of those provisions emphasizes the applicability here of the general rule that an excepting clause is to be narrowly construed.

The Commissioner's notices of deficiency gave the petitioners no notice of the particular exception or exceptions upon which he relied. In his answer, however, by way of denial, the Commissioner placed reliance upon all of them. As the statutory provision shows, there were four such exceptions:

1. "Stock in trade of the taxpayer",
2. "Other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year",
3. "Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business",
4. "Property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(1)".

II.

The Patents Involved Were Not "Stock in Trade of the Taxpayer", Nor "Other Property of a Kind Which Would Properly Be Included in the Inventory of the Taxpayer if on Hand at the Close of the Taxable Year", Nor "Property Held by the Taxpayer Primarily for Sale to Customers in the Ordinary Course of His Trade or Business."

The Tax Court in its opinion stated:

> "While it may be doubtful whether the patents involved constituted petitioner's stock in trade or property of a kind which would properly be included in inventory or property held primarily for sale to customers in the ordinary course of business, . . ." [R. 46.]

The Court thus took the patents out of the first three statutory exceptions to capital asset classification.

The facts amply support that result. Petitioner was not in the business of selling patents. Other than the patents involved here he never sold any patents to any one. As to the patents involved here, he never held them for sale to any one. The actual sale here, furthermore, was not to a mere "customer." The vendee, the Gerrard Company, was at that time, and had been since 1930, the exclusive licensee of those patents, and was obligated under the license to pay petitioner a minimum royalty of $30,000 per year. Nor was the sale in "the ordinary course of business", since the purpose of the sale was to obtain capital for expansion purposes.

Plainly then the patents involved here were not "stock in trade of the taxpayer." It must also follow that they were not "other property of a kind which would properly be included in the inventory of the taxpayer if on hand

at the close of the taxable year." The term inventory is applicable only to items "which have been acquired for sale or which will physically become a part of merchandise intended for sale." [Reg. 111, Sec. 29.22(c)-1, Appendix herein, p. 4.] Definitely these patents were not in that category. It must follow, too, that these patents were not "property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business." In *Samuel E. Diescher v. Com.*, 36 B. T. A. 732, the Board stated, at page 743:

> "He [the Commissioner] argues that the patents were held by the partnership primarily for sale in the course of its business. As to this, the record discloses nothing, in our opinion, indicating that the partnership has ever been in the business of buying and selling patents or in developing inventions for patent and sale. So far as we know, the patents involved here are the first which the partnership has ever sold, although it has been in business for many years. All of the other transactions having to do with the patents of the partnership have been connected with the licensing of their use. The basic patent involved in the exchange between the partnership and the newly organized corporation, and which represents the largest individual value among the patents and inventions exchanged, had been owned for many years by the partnership. During that time its use by other companies had been granted under license agreements. It is evident that the patents and inventions here in dispute did not constitute stock in trade, held for sale by the partnership in the course of its business."

The Tax Court reaffirmed that view in *Edward C. Myers v. Commissioner,* 6 T. C. 258. To the same effect is *Bessie B. Hopkinson v. Commissioner,* 42 B. T. A. 580, 581, affirmed C. C. A. 2, 126 F. 2d 406.

III.

The Patents Involved Were Not "Property, Used in the Trade or Business, of a Character Which Is Subject to the Allowance for Depreciation Provided in Section 23(1)."

(a) This Exception in the Definition of Capital Assets Should Not Only Be Narrowly Construed; Any Doubt in Its Meaning Should Be Resolved in Favor of the Taxpayer.

(1) The application of this exception in the definition of capital assets to these petitioners is prejudicially retroactive.

This exception was added to the statute under the Revenue Act of 1938, enacted May 16, 1938. The sale involved here, however, took place on March 21, 1938. It is true that retroactive application of income taxes has been held constitutional. This does not, however, remove the possibility that in a particular case such application may be unfair and unjust. Here a taxpayer made a sale in the well grounded belief that the sale was a sale of capital assets. He even sought advice in that respect and received it. His purpose in making the sale, to enable him to obtain capital for productive investment, was of the very kind for which the capital gain provisions were enacted. (Report—Senate Finance Committee, *supra.*) The notes which he received were worth face value at the time received. With such capital he was indeed empowered to expand his operations as he desired.

Only after the transaction was complete and irrevocable was this exception in the definition of capital assets engrafted upon the law. It has been held that tax laws are to be "construed and applied with a view to avoiding,

so far as possible, unjust and oppressive consequences." 1 Mertens 62. More specifically, it has recently been stated by the Supreme Court: "Retroactivity, even where permissible, is not favored, except upon the clearest mandate . . . The letter does not require this. The consequences forbid it." *Claridge Apartments Co. v. Com.*, 323 U. S. 141, 164, 65 S. Ct. 172. Here the application sought of a statutory provision is prejudicially retroactive. Under such circumstances the taxpayer is at least entitled to have any doubts resolved in his favor.

(2) The application of this exception in the definition of capital assets to these petitioners is not within the intent of Congress.

In presenting this provision to the floor of the House, the Committee on Ways and Means stated:

> "The definition of capital assets is slightly modified so as to exclude from the definition, property used in the taxpayer's trade or business, which is subject to depreciation allowances. This, in the great majority of cases, should be of benefit to the taxpayer, since it will allow him to take losses against his ordinary income from the sale of such property. Under existing law, if a taxpayer loses on the sale of depreciable property, he can not charge it off against ordinary income and can only receive a deduction if he has capital gains. Moreover, the loss taken into account is reduced according to the length of time during which he has held such property. Under the proposed change, he will be able to charge off the full amount of the loss against his ordinary income." Report—Ways and Means Committee, 75th Cong. 3d Sess. House Rept. 1860, 1939-1 C. B. Part 2, pp. 728, 732.

The Committee illustrated the operation of the provision as follows:

> "Suppose that X, a manufacturer, purchased in 1932 a large machine, at a cost of $50,000. At the time of acquisition and installment in his plant, the machine had an estimated useful life of 10 years. X was therefore allowed an annual deduction from gross income for depreciation on the straight-line method of one-tenth of the cost, or $5,000, with respect to this machine. Assume that in 1938, when the machine has been in use for six years, a new and improved type of machine is introduced, the installation of which would materially reduce X's costs of production. X has, however, recovered only 60 per cent of the cost of the old machine through the annual deduction for depreciation. Let it be further assumed that X could sell the old machine to Y, another manufacturer, for $7,500, which is only 15 per cent of its cost to X, but is materially in excess of its junk or salvage value. If such a sale were consummated, X would sustain an actual loss of $12,500 on this machine. The result of section 117(a)1 of the present bill is to allow X to deduct this loss in full from gross income, whereas, but for such provision, section 117(b) would limit X to a deduction of 40 per cent of this amount, or $5,000, of which not more than $2,000 could be applied against income other than long-term capital gains." (*Ibid.*, pp. 752-53.)

The Senate Finance Committee, in presenting this provision to the floor of the Senate, stated:

> "The definition of capital assets has been changed, so that depreciable assets are no longer included in the category of capital assets. This change made in the House bill allows a corporation to receive the

full benefit of a deduction for losses on the sale of depreciable assets from its ordinary income." Senate Report No. 1567, 75th Cong. 3d Sess., 1939-1 C. B. Part 2, pp. 779, 783.

Clearly then it was the intent of Congress in enacting this change in the definition of capital assets to liberalize the definition in favor of the taxpayer because of the inadequacy in certain cases of the allowance for depreciation. Certainly that change was never intended to draw within its scope such property as is here before this Court, in which there is utterly no relation between cost and value, and in which depreciation as a result could never be a significant factor.

(b) The Patents Involved Here Were Not Used in the Taxpayer's Trade or Business.

(1) The determination whether these patents were property "used in the trade or business," within the meaning of the clause in Section 117(a)(1) of the Internal Revenue Code excepting such property, depends on whether the patents were so used at the time of sale.

In presenting the exception of property "used in the trade or business" to the floor of the House the Committee on Ways and Means stated:

> "It should be noted, however, that it is limited to property used by the taxpayer in his trade or business at the time of the sale or exchange . . ." House, etc. 1939-1 C. B. Part 2, pp. 728, 753.

The same point is made in *R. W. Albright v. U. S.* (D. C. Minn.), 76 Fed. Supp. 532, Mar. 18, 1948, in which rulings of the Commissioner to that effect were sustained.

Under those rulings the Commissioner held that property "used in the trade or business," within the meaning of Section 117 of the Internal Revenue Code, was limited to property so used at the time of its sale; and that therefore livestock acquired by a taxpayer for use in his trade or business, and so used, but later separated out for sale to customers in the ordinary course of his trade or business, was not property "used in the trade or business" for the purpose of Section 117 of the Internal Revenue Code; and the court in the *Albright* case approved those rulings. It is shown also in *B. G. Lurie v. Commissioner* (C. C. A. 9), 156 F. 2d 436, that the definitions in Section 117 are referable to the time of the taxable transaction.

(2) It is immaterial whether the round wire patents were used in petitioners trade or business since the total proceeds of the sale were attributable to the flat band patents, and the flat band patents had no relation to the round wire patents.

The facts show that the entire proceeds of the sale were attributable to the flat band patents. Furthermore, the flat band patents had no relation to the round wire patents. The flat band business was restricted by the flat band patents, but any one could get into the round wire business. It is immaterial therefore whether the round wire patents were used in petitioner's trade or business. The question is solely whether the flat band patents were so used.

(3) In 1938 when petitioner sold his flat band patents to Gerrard he was with respect to such patents a mere passive recipient of minimum royalties under the license granted by him to Gerrard in 1930.

The basic facts in regard to the flat band patents are that: (a) no machines were manufactured by petitioner under them, except for models in 1930 or 1931; (b) from 1931 on those patents were under license to Gerrard at a minimum royalty of $30,000 per year; (c) no royalty beyond such minimum was ever paid him; (d) his only work in connection with those patents after 1931 was completion of applications and improvements in process; (e) none of even such work continued into the last two or two and one-half years prior to the sale on March 21, 1938; and (f) when petitioner sold them he did so in order to obtain capital with which to expand into larger business.

The conclusion is clear that with respect to these patents petitioner at the time of the sale was a mere passive recipient of minimum royalties under the license granted by him to Gerrard in 1930.

(4) The mere passive receipt of royalties by petitioner was not in itself a trade or business.

In order that anything be classified as a trade or business there must be at least a regularity and continuity of time, attention and labor devoted to carrying it on. *Snyder v. Commissioner,* 295 U. S. 134; *Van Wart v. Commissioner,* 295 U. S. 112; *Higgins v. Commissioner,* 312 U. S. 212. Even the case of *John Fackler v. Com.* (C. C. A. 6), 133 F. 2d 509, upon which respondent will undoubtedly rely, does not deny that. There it was necessary for the taxpayer to "furnish elevator service, heat, light and water which required regular and continuous activity and the employment of labor, the buying of material and many other things which come within the definition of business." More recently, in *Fahs v.*

Crawford (C. C. A. 5), 161 F. 2d 315, 318, the court, sustaining the taxpayer, pointed out:

> "Carrying on a business, however, implies an occupational undertaking to which one habitually devotes time, attention and effort with substantial regularity."

The conclusion must follow that petitioner's passive receipt of minimum royalties did not in itself constitute a trade or business.

(5) These patents were not used in petitioner's trade or business merely because they may have originated in his trade or business.

The Tax Court in its opinion answers point (4) above as follows:

> "Nor do we consider it realistic to look only at the receipt of royalties divorced from the efforts and accomplishments leading up to such receipt and to say such passive receipt does not constitute a business." [R. 48.]

Here the Tax Court is confusing the origin of a thing with its use. The act or process of creating something or bringing something into being is one thing; the act or process of using it or carrying it on is something wholly different. *McDonald v. Commissioner,* 323 U. S. 57. In that case the Supreme Court sustained the denial of a deduction for expenses incurred in campaigning for office, pointing out that such expenses represent the cost of getting the office, not of carrying it on.

Even if one assumes then that the patents here originated in petitioner's business—which petitioners do not

concede—they were not for that reason used in his business.

(6) Petitioner's flat band patents were therefore mere investments and not property "used in the trade or business."

It has been shown that the receipt of the royalties on the flat band patents was not in itself a trade or business, and that the patents were not property used in a trade or business merely because they may have originated in a trade or business. Nor is there any other basis suggested by the record upon which a contention of such use can be predicated. Certainly at the time of their sale in 1938 these patents were mere investments.

The fact that they were sold to obtain capital for expansion emphasizes this fact. One does not normally sell an asset *used* in the business in order to raise capital for *expanding* the business. Indeed, the purpose of the sale is the very purpose for which the capital gain provisions were enacted. As above observed, those provisions were enacted because it was found that "an excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments." Report—Senate Finance Committee, 75th Cong. 3d Sess. S. Rept. 1567, page 6; 1939-1 C. B. Part 2, p. 783. Whatever may have been the origin of the patents here involved, at the time of the sale they were mere investments and not property used in a trade or business.

Certainly, considering all of the circumstances here and the limited construction to be given the statutory provision, as outlined in point I above and part (a) of this point III, the conclusion is warranted that the flat band patents were not property used in the trade or business.

Issue No. 2: Whether Certain Portions of the Sales Price Paid by Petitioners to Others Can Properly Be Excluded From or Offset Against the Selling Price, and Whether in That Connection the Tax Court Should Have Granted Petitioners' Motion for Rehearing.

I.

For This Purpose the Payments Must Be Classified as Capital Expenditures, So That It Is Unnecessary to Show That They Were Ordinary and Necessary and Reasonable but Only That They Were Bona Fide and Actually Incurred in Connection With the Transaction.

The application of an expense incurred in connection with a sale as an *exclusion* from or *offset* against the selling price is not dependent upon its being "ordinary and necessary," and "reasonable," as required in the case of a *deduction* under Section 23(a) of the Internal Revenue Code for compensation paid for personal services. Such application of an expense as an exclusion or offset is not made under Section 23(a), but under Section 22(a) in arriving at the gross income from the transaction. In *Victoria Paper Mills Co. v. Com.*, 32 B. T. A. 667, affirmed *per curiam*, C. C. A. 2, 83 F. 2d 1022, the Board stated:

> "The rule is well settled that commissions and other similar charges, including attorney fees, incident to the sale of or other disposition of property ordinarily are to be treated as *capital* expenditures and are de-

ductible from the selling price in determining the amount of the gain or loss on the transaction." (Italics supplied.)

The Internal Revenue Code contains no specific requirements in regard to capital expenditures. It provides only, in so far as here pertinent, as follows:

a. In Section 111(a), that the "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain," and

b. In Section 113(b), that in determining such adjusted basis proper adjustment in respect of the property shall "in all cases" be made for "expenditures, receipts, losses, or other items, properly chargeable to capital account, . . ."

It is fair to conclude that with respect to the payments to Lawrence and Herbert it is sufficient to show that the payments are *bona fide* and that they were actually incurred in connection with the sale of the patents.

II.

The Payments to Lawrence Were Bona Fide and Actually Incurred in Connection With the Sale of the Patents, and Should Therefore Be Allowed as Capital Expenditures.

Petitioner engaged his son, Lawrence, to negotiate a sale of the patents to Gerrard, agreeing in advance to compensate him if he succeeded. He did succeed. The necessary implication is that he succeeded in making a deal satisfactory to petitioner. The amount of the sale was large, $425,000. The notes received as a part of the sales price were worth face value when received.

Lawrence, indeed, was only 28 years of age at the time. But that is an extremely weak objection. Many of the greatest accomplishments in history were those of men under that age. Alexander the Great died at 32, having conquered much of Europe and most of Asia. Keats died when he was 26, having become one of the greatest poets of all time. Einstein first announced his theory of relativity in 1905, when he was only 26. Hutchins became president of the University of Chicago when he was 29. Any biographical dictionary will reveal hundreds of such names. Lawrence's youth cannot be used as a point here.

Lawrence's task was certainly not a simple one. His only instruction was to make a deal. Although he was an attorney, his task was as negotiator. In other words, it was his job to negotiate the sale, at a price and on terms satisfactory to petitioner. When petitioner agreed to pay him 20 per cent of the proceeds of the sale as his compensation petitioner knew, not only that there would be no tax saving, but that on the contrary there would be a tax loss instead. The *bona fides* of the payments cannot be

questioned; and clearly they were incurred in connection with the sale. They should therefore be allowed as capital expenditures in arriving at the gain on the sale.

III.

The Payments to Herbert Were Payments for His Interest in the Patents.

Herbert had assisted petitioner in developing the patents, advising and discussing in reference to them evenings, Sundays and holidays. Petitioner paid him 10 per cent of the annual minimum royalty received from Gerrard. When the patents were sold he settled with Herbert by agreeing to pay him $2,500 out of each payment of $40,000 received from Gerrard. In the contract of sale petitioner expressly agreed to transfer not only his own interest in the patents but any interest Herbert might have.

Petitioner and Herbert were brothers. It is not unusual for brothers working together as long as these did to have understandings which are not put into so many express words but which are nevertheless recognized between them and carried out in their actual conduct. The payment to Herbert of 10 per cent of the royalties, each and every month, from the very inception in 1930 and right up to the sale in 1938 cannot otherwise reasonably be regarded. The undertaking in the contract of sale to transfer Herbert's interest as well as his own but reinforces that conclusion. The Tax Court made no finding of fact that Herbert had no interest in the patents; but if it had, such finding would be in clear conflict with the evidence. The payments to Herbert of $2,500 out of each $40,000 received on the sale of the patents should be excluded or deducted therefrom as payment to Herbert for his interest in the patents.

IV.

In Any Event, the Payments to Herbert Were Capital Expenditures Incurred by Petitioner in Connection With the Patents and Therefore Deductible as Offsets Against the Selling Price.

Assuming that Herbert had no interest in the patents, the question remains whether the amounts paid him were *bona fide* payments in connection with the patents and therefore capital expenditures deductible in any event as offsets against the selling price. The Tax Court concedes in its opinion that Herbert assisted petitioner in his work on the inventions and that his advice was "invaluable" to petitioner. [R. 49.] According to Webster's Unabridged Dictionary, "invaluable" means "valuable beyond estimation, inestimable, priceless, precious." It must follow that petitioner's payment to Herbert of only $2,500 out of each $40,000 received by him on the sale of the patents was a gross underpayment. It must follow also that the Tax Court's refusal to exclude that amount in arriving at the gain to petitioner was arbitrary and a gross miscarriage of justice.

Even if the tests of "ordinary and necessary" and "reasonable" were applied, as they would be if the payments were for services rendered in the carrying on of a trade or business, even then the payments would merit allowance. It would be immaterial, of course, that Herbert's services were rendered in prior years. (*Lucas v. Ox Fibre Brush Co.,* 281 U. S. 115.) It would be immaterial also whether petitioner was obligated to make the payments to Herbert. [*Ibid.*] It would only be necessary to show that the services were worth the payments made; and the Tax Court has amply conceded that. *A fortiori* here, where the tests of "ordinary and necessary" and

"reasonable" are not applicable, where the question is solely one of *bona fides*, the payments being claimed as capital expenditures, their deduction should be allowed.

V.

The Tax Court, Having Found That Services Were Rendered by Lawrence and Herbert, Was at Least Under a Duty to Make a Determination and Finding as to Their Value and to Allow Such Amount as Deductions; and to That End, If Necessary, the Court Should Have Granted Petitioners' Motion for Rehearing.

It is clear since *Helvering v. Taylor*, 293 U. S. 507, that the Tax Court bears an administrative burden. The Tax Court cannot relieve itself of the burden of determining a value, or a reasonable amount, wherever such factors are in issue, merely because the taxpayer's evidence was inadequate. The *Taylor* case involved a valuation of property. In *George M. Cohan v. Commissioner* (C. C. A. 2), 39 F. 2d 540, the same principle was applied in determining an amount allowable as "ordinary and necessary" expenses. More recently, in *W. D. Haden Co. v. Commissioner* (C. C. A. 5), 165 F. 2d 588, the Court stated:

> "It is also clear that if the sales contracts drew no interest they ought to be discounted according to the prevailing rates of interest to find their then value. That is a matter of law. But we do not think that because an appraisement was not made in 1932, or because neither side asked the witness as to value to figure out this discount, the court is excused from doing it. Law and justice require either that the Tax

> Court should figure it out for itself, or having announced that this must be done to arrive at a proper value, should reopen the hearing that the taxpayer may supply the omission. As to this item we set aside the disallowance and direct that the hearing be reopened for further evidence."

Here the Tax Court, in reference to the payments to Lawrence, found as a fact that he had "assisted petitioner in negotiating the sales contract with Gerrard." Clearly then the Commissioner was in error in allowing no deduction at all in respect of the payments to Lawrence. Yet the Tax Court, observing that Lawrence did not testify at the hearing, and that it had "only petitioner's very vague recitations as to his son's services," simply sustained the Commissioner's determination. We contend that petitioner's evidence in this respect was not vague but clear and full. Be that as it may, however, the Tax Court was under a duty to make a determination of value.

The same is true in regard to the payments to Herbert. With respect to both Lawrence and Herbert the petitioners sought a rehearing for the purpose of taking their testimony, and in that connection filed affidavits showing what such testimony would contain. In the light of the *Haden Co.* case, *supra,* since the Tax Court had failed to make a determination of value of the services of Lawrence and Herbert, its failure to grant the rehearing was improper.

Issue No. 3: Whether the Tax Court Should Have Granted Petitioners' Motion for Judgment on the Pleadings.

I.

Except for Treatment of the Sale of Patents to Gerrard in 1938 as a "Casual" Sale Under Section 44(b) of the Revenue Act of 1938 There Is No Basis for Including in Petitioners' Gross Income in Any of the Taxable Years Here Involved Any Part of the Proceeds of the Said Sale.

The sale of patents took place in 1938. The total consideration was $425,000. Of said total $25,000 was payable and paid upon execution of the sale; and the balance of $400,000 was payable and paid at the same time by delivery to petitioner of 10 negotiable promissory notes in his favor in the sum of $40,000 each, jointly made by Gerrard and its parent company, the American Steel and Wire Company of New Jersey. In filing their return for 1938 petitioners elected to return the gain on said sale on the installment basis under Section 44(b) of the Revenue Act of 1938 [App. p. 1], but otherwise filed their returns for the year 1938 on the accrual basis. All this was alleged by petitioners in their petitions and admitted by the Commissioner in his answers.

The years involved here do not include 1938, but only the years 1939, 1940 and 1941. Under the accrual method, which the petitioners used except for the election made by them under Section 44(b) of the Revenue Act of 1938 with respect to the sale of patents, the notes were necessar-

ily includible in gross income in 1938. (*U. S. v. Anderson*, 269 U. S. 422; *Continental Tie and Lumber Co. v. U. S.*, 286 U. S. 290.) This would be true even if the notes became bad in whole or in part before the year of sale was over. Relief then could be had only through a deduction for bad debts. (*Spring City Foundry Co. v. Commissioner*, 292 U. S. 184.) Even on a cash basis, except for the installment election, those notes were includible in gross income in 1938. (*Wolfson v. Reinecke* (C. C. A. 7), 72 F. 2d 59; *Cherokee Motor Coach Co., Inc., v. Com.* (C. C. A. 6), 135 F. 2d 840.)

Section 44(a) of the Revenue Act of 1938, quoted in the Appendix, page 1, is inapplicable, since by its terms it applies only to a dealer who regularly sells on the installment plan, and with respect to the entire installment business; it cannot apply to a single transaction. (G. C. M. 1162, VI-1 C. B. 22.) Except for Section 44(b), which in respect to personal property applies only to a "casual" sale, there is no basis in the revenue law for including in petitioners' gross income in any year after 1938 any portion of the total consideration of $425,000, or any amounts with respect to the payments received on the notes of $40,000 each which were part of that consideration.

II.

The Portion of Section 117(a)(1) of the Internal Revenue Code Under Which Are Excepted From Capital Assets Classification,

1. **"Stock in Trade of the Taxpayer"**
2. **"Other Property of a Kind Which Would Properly Be Included in the Inventory of the Taxpayer if on Hand at the Close of the Taxable Year," and**
3. **"Property Held by the Taxpayer Primarily for Sale to Customers in the Ordinary Course of His Trade or Business,"**

Cannot Apply to a Sale Returnable as a "Casual" Sale Under Section 44(b) of the Revenue Act of 1938.

Section 44(b) of the Revenue Act of 1938 is quoted in the Appendix, page 1. In 1939 it became, without change, Section 44(b) of the Internal Revenue Code. Under that subsection a disposition of personal property for a price exceeding $1,000 is returnable, at the taxpayer's election, on the installment plan if it is a "casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year)."

The parenthetical portion of the provision was adopted in 1928 and was merely declaratory of existing law. The House and Senate committees reported that insertion in the law as follows:

> "The committee regards as properly interpretative of existing law the departmental ruling that the sale of an item of the taxpayer's inventory should under

no circumstance be regarded as a casual sale." (1939-1 C. B. Part 2, pp. 394, 425.)

The subject resulted in the following interchange on the floor of the House:

> "Mr. Hastings: Will the gentleman tell me what is meant by the language 'casual sale or other disposition of personal property'?
>
> Mr. Green of Iowa: That is a single sale that is not in the regular business.
>
> Mr. Hastings: Is that in the existing law?
>
> Mr. Green of Iowa: Yes; that is the same as in the existing law. It has been that way for a long while and we have never had any trouble with the provision." (69 Cong. Rec. 513-514.)

It is clear, of course, from the parenthetical portion of the provision quoted from Section 44(b) that a sale of property of a kind includible in the taxpayer's inventory cannot come within that provision. It is clear also that if petitioner's sale of patents was a sale of "stock in trade" of his, or of property held by him "primarily for sale to customers in the ordinary course of his trade or business" it was not a "casual" sale. (G.C.M. 1162, VI-1 C. B. 22; *50 East 75th Street Corporation* (C. C. A. 2), 78 F. 2d 158; *E. M. Funsten v. Commissioner,* 44 B. T.A. 1166.) In the *Funsten* case, involving a sale of securities, the Board stated, at page 1169:

> "In the *McCutcheon* case the sale was by a security company and manifestly occurred in the regular course of business. It did not fall within subsection (b) because it was not a casual sale . . ."

It must follow that the portion of Section 117(a)(1) of the Internal Revenue Code under which are excepted from

capital asset classification "stock in trade of the taxpayer," "other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year," and "property held primarily for sale to customers in the ordinary course of his trade or business," cannot apply to a sale returnable as a "casual" sale under Section 44(b) of the Revenue Act of 1938.

III.

Since the Commissioner in His Answer Took a Position Inconsistent With the Treatment of the Sale of Patents to Gerrard as a "Casual" Sale, the Petitioners' Motion for Judgment on the Pleadings Should Have Been Granted.

(a) A motion for judgment on the pleadings should be granted where the position taken by the opposite party on the facts, if it represented the truth, would require such a judgment, and such opposite party fails to amend.

A motion for judgment on the pleadings is in the nature of a demurrer. It is in substance both a motion and a demurrer: a demurrer for the reason that it attacks the sufficiency of the pleadings, and a motion for the reason that it is an application for an order for judgment. On a motion for judgment on the pleadings every allegation affirmatively set up in the answer must be deemed true, and every allegation of the party moving which has been controverted must be deemed untrue. (*Osborne v. Abels,* 30 Cal. App. 2d 729, 730-731, 87 P. 2d 404. To same effect, *N. Y. Life Insurance Co. v. Bidoggia et al.* (Dist. Ct. Idaho), 17 F. 2d 112; *Compagnia Italiana Transporto Olii Minerali v. Sun Oil Co.* (Dist. Ct. N. Y.), 29 F. 2d 744; *Smith v. Beauchamp,* 71 Cal. App. 2d 250, 256, 162 P. 2d 662.) This point with respect to any allegation ex-

tends to all fair inferences to be drawn from the allegation. (*Frank Gilbert Paper Co. v. Prankard,* 204 App. Div. 83, 198 N. Y. S. 25, aff'd. 195 N. Y. S. 638.) And where, after motion for judgment on the pleadings has been made and the defects in opposing party's pleadings pointed out, he fails to ask leave to amend, it will be assumed that his pleading states the case as favorably to him as possible. (*Gross v. Bank of America, Nat. T. & S. Assn.,* 4 Cal. App. 2d 353, 355, 41 P. 2d 178.)

(b) The Commissioner in his answer took a position on the facts which, assuming it to represent the truth, would require judgment for petitioners, and the Commissioner failed to amend.

The Commisioner in his answer denied petitioners' allegations that the patents sold were not stock in trade of petitioner, or other property of a kind which would properly be included in his inventory if on hand at the close of the taxable year, or property held by him primarily for sale to customers in the ordinary course of his trade or business. The Commissioner thus took the position that the patents were such property. From the analysis under points I and II above it follows that in his answer he took a position inconsistent with treatment of the sale as a "casual" sale, and therefore inconsistent with the inclusion in gross income, for the taxable years here involved, of any part of the proceeds of the sale.

All that petitioners asked for in their petition was exclusion from the proceeds of the said sale of the portion paid Lawrence and Herbert, and treatment of the balance as capital gain. At no time have they asked for more. Therefore, if a position of the Commissioner inconsistent with inclusion in gross income of *any part* of the proceeds

of the sale represented the true state of the facts, there would be nothing left to try, and a judgment for petitioners would be required.

The Commisioner took such a position in his answer. After petitioners by motion for judgment on the pleadings point out the defect, he made no attempt to amend. On the contrary, at the opening of the hearing he expressly stated that it would be his contention, *inter alia,* that the patents were property held by petitioner "primarily for sale in the ordinary course of the trade or business." It follows that the motion for judgment on the pleadings should have been granted.

Conclusion.

Petitioners submit that the gain resulting from the sale of the flat band patents to Gerrard in 1938 should be treated as capital gain; that the amounts paid out of the proceeds of said sale to Lawrence A. Harvey and Herbert Harvey should be allowed as offsets against the selling price; and that petitioners' motion before the Tax Court for judgment on the pleadings should have been granted.

If this Court believes that additional findings of the Tax Court may be necessary in any respect, petitioners request that the cause be remanded for that purpose.

Respectfully submitted,

George T. Altman,

Attorney for Petitioners.

October 1, 1948.

APPENDIX.

Statutes.

Revenue Act of 1938:

"SEC. 44. INSTALLMENT BASIS.

"(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

"(b) *Sales of Realty and Casual Sales of Personality.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price . . ., the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section . . ."

* * *

Internal Revenue Code:

"SEC. 22. GROSS INCOME.

"(a) *General Definition.*—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . ., of whatever

kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; . . ."

* * *

"Sec. 23. Deductions From Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) *Expenses.*—

"(1) *Trade or Business Expenses.*—

"(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . ."

* * *

"(2) *Non-Trade or Non-Business Expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

* * *

"Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

"(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, . . ."

* * *

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS."

* * *

"(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

"(A) For expenditures, receipts, losses, or other items, properly chargeable to capital account, . . ."

"SEC. 117. CAPITAL GAINS AND LOSSES.

"(a) *Definitions.*—As used in this chapter—

"(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1); . . ."

* * *

Regulations.

Regulations 111:

"Sec. 29.22(c)—1. Need of inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, . . ."